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Central Intelligence Agency

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DIRECTORATE OF INTELLIGENCE

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1 July 1983

CHINA: MOUNTING ECONOMIC MANAGEMENT PROBLEMS [redacted]

Summary

Premier Zhao Ziyang, in his 6 June government work report to the National People's Congress, warned that China's investment spending is "out of control" and criticized the government for its "failure to take sufficiently forceful measures" to remedy the situation. Partly to blame, said Zhao, are economic reforms that decentralized production and investment decisions. Beijing late last year took steps to recentralize at least part of the investment decisions but, judging from first-quarter 1983 statistics, these measures have met with scant success. We believe Beijing will be forced to take much stronger steps--perhaps undercutting elements of the government's economic reform program--lest current trends significantly hamper long-range development plans. [redacted]

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China began the period following the 1976 fall of the Gang of Four with a high-speed development program cast in the mold of past attempts: rapid heavy industrial growth to support a massive investment campaign, and a corresponding lack of emphasis on consumer welfare and light industry. The Third Plenum in December 1978 repudiated this approach and redefined China's economic goals, putting balanced growth and improvements in living standards first. To implement this policy, China undertook economic management reform and decentralized some decision-making functions. Although agriculture has grown impressively--justifying Beijing's policies--the rest of the economy has not fared as well. [redacted] 25X1

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Investment: Growing and Unmanageable

The government has attempted unsuccessfully to cut investment rates ever since late 1978.[1] This departure from policy tradition has been necessary because, with too few construction inputs and too many projects, construction times for even the most critical projects are unacceptably long. A second motivation has been the goal of raising living standards, to be achieved partly by deemphasizing investment. 25X1

Although generally in keeping with state plans, investment spending hit historic peaks in 1979 and 1980 (see table 1 for investment data). In early 1981, the government called for "readjustment," slashing the original 55 billion yuan investment target for that year to 30 billion yuan. This move was taken--on the advice of Chen Yun, Deng Xiaoping's most seasoned economic policy advisor--as a drastic measure to implement investment-cutting policies we believe the Deng group was unable to legislate in 1979 or 1980. Although investment spending by yearend 1981 was below the preceding year, it still exceeded the plan by nearly 50 percent.[2] Investment controlled by the state budget was only 20 percent over plan, but investment outside the budget was 80 percent over plan.[3] 25X1

In 1982, government pleas and warnings to cut investment were again ignored and investment overshot the relatively austere 38 billion yuan target for the year, this time by over 40 percent. In fact, 1982 investment was a record 55.5 billion yuan, 11 billion yuan over the preceding year. Investment from all sources of funds exceeded the plan, with that from discretionary enterprise earnings outstripping the target by over 100 percent. 25X1

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[1] The term "investment" throughout this typescript refers to new fixed investment in state-owned enterprises. 25X1

[2] We are comparing final data with the original plan. In fact, in both 1981 and 1982, Beijing revised upward its investment targets halfway through the year, a move we believe made virtue of necessity. 25X1

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[3] As table 1 shows, investment spending comes from a variety of sources. The source the government can most easily control is spending from the state budget. Spending from retained enterprise earnings is least susceptible to government management, while spending from domestic and foreign loans falls between these extremes. 25X1

Industry: Overreacting

We believe that Beijing's difficulty in guiding industrial production stems from its inability to control investment. In line with its investment-cutting policy, the government early in 1979 sought to redress the imbalance between producer goods and consumer goods production by giving priority to the long-neglected light industry sector. Industrial results in 1979 were close to the plan, with light industry up at a slightly higher rate than heavy industry (see table 2 for industry data). In 1980 and 1981, however, the economy overreacted to pro-light industry policies: heavy industry in 1981 dropped below 1979 production levels. Although the rapid growth of light industry was in the right direction, it overshot the target. The traditional complaint against heavy industry--that it turned out unusable, poor quality products--was in 1980-81 used to characterize light industry for the first time. 25X1

In 1982 the economy simply did not comply with the plan, which called for 7-percent light industry growth and a 1-percent heavy industry increase. Heavy industry grew at nearly a 10-percent rate for the first time since 1978. Light industry fell below the plan in spite of a public continuation of the "light industry first" policy. Production data for the first quarter of 1983 show that the 1982 trend continues, with light industry falling even further behind heavy industry. 25X1

What Went Wrong?

Economic reforms have created conditions in which central government plans for investment can be largely ignored. Budget reforms implemented in 1980 have given local governments greater control over spending, and enterprise management reforms since 1979 have permitted enterprises to retain a growing share--reported to be about one-quarter now--of their profits. Chinese press sources claim that the pool of extrabudget discretionary funds was over 60 billion yuan in 1982, against a government budget that year of only about 100 billion yuan. 25X1

The reforms also have given enterprises and production ministries increased authority over production decisions. The strong government support for light industry and scathing criticism of heavy industry in 1980-81 apparently depressed the demand pull of investment on heavy industry. By 1982, however, we believe heavy industry producers began to take advantage of the market-oriented environment that light industry more rapidly adapted to in 1980.[4] In our view, investment demand for producer goods and a visible drop in criticism of heavy industry in 1982 permitted the strong heavy industry resurgence that left light industry in its wake.[5] 25X1

Beijing, presumably fearing a repeat performance in 1983, late last year legislated a 30-percent tax on nonbudget investment that exceeds the plan. At the same time, Premier Zhao Ziyang announced that 10 percent of all retained earnings must be turned over to the central government for use in critically needed energy and transport projects. The 1983 investment plan is set slightly below last year's record level, with increases in budget-controlled spending supplanting decreases in investment from retained earnings (see table 1). Sixth Five-Year Plan investment requirements are high and the government wishes to maximize control over how the funds are spent. 25X1

Beijing also has expressed concern about overproduction in heavy industry and about light industry's inability to come even close to the target in the first quarter this year. A national industrial conference was convened in late March, but press reporting disclosed much less strident criticism of the swing back to heavy industry than we expected. The conference reaffirmed the program initiated in 1980 of priority inputs for light industry, but this call was mild compared with publicity for this program in 1980-81. Beijing presumably is trying to coax the economy toward balanced growth rather than using the

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[4]Historically, heavy industry enterprises have produced according to government orders, not to satisfy market demand. Light industry, although also producing for government orders, has typically been more flexible. When government orders for heavy industry were drastically cut in 1981, heavy industry's inexperience prevented it from effectively interacting with end-users of its products. Two years' experience has paid off. For example, strong rural demand for small tractors finally was translated into a 50 percent increase in tractor production in 1982, after successive drops in production over the preceding three years. 25X1

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[5]Although Beijing continued to proclaim publicly a pro-light industry policy, the statements were more tempered, and explained that heavy industry also served an important function. 25X1

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more heavy-handed tactics of the 1981 readjustment.

Implications and Prospects

Beijing's inability to control these important economic variables has serious implications for both short-term performance and long-term development plans. The excessive growth of heavy industry since the final quarter of 1981 has built up pressure on an already strained energy sector. As more energy and raw materials are channeled to meet growing heavy industry demand, light industry growth rates have dropped off. In the first quarter of this year, heavy industry growth surged to an 11.7 percent rate, squeezing light industry down to a 2.5-percent rate for the quarter, well below the 4.1-percent target for 1983. 25X1

Critical to China's long-term development plans is the 6th Five-Year Plan's emphasis on qualitative rather than quantitative economic progress. In this plan period--and for the rest of the decade--Beijing is asking industrial producers to keep production increases within the moderate plan in order to focus on improving productivity and to permit energy and transport capacity to catch up to demand. A two-pronged attack on these bottlenecks, building new capacity and retooling inefficient users of energy and raw materials, is scheduled to last through the 1980s. Beijing fears--and we believe these fears are legitimate--that if industrial producers go all out for production increases and if low priority investment continues to rise, government plans to ease energy and transport shortages will be seriously undercut. 25X1

Premier Zhao, speaking in early June at the National People's Congress, complained that the government has "failed to take sufficiently forceful measures" to regain control of investment. Indeed, a pre-NPC People's Daily editorial warned that if current investment trends continue, China may have to take the sort of drastic moves it did in early 1981. Zhao, though very critical, was not explicit about new measures to resolve the problems and did not threaten a new readjustment campaign. 25X1

We believe that Beijing would prefer not to prescribe the strong medicine it felt compelled to use in late 1980-early 1981 to readjust the economy, slashing investment and other spending. That remedy brought the economy up short, producing the lowest growth rates in recent years and unsettling foreign investors and domestic producers. A noted government economist recently urged that tax and price policies be used to guide the economy along the desired growth path, but Zhao's NPC work report stopped short of calling for similar measures. We believe Beijing will try quietly to recentralize control and that this ultimately will alter elements of the government's economic reform program, scheduled for implementation after 1985. 25X1

Table 1: Chinese Investment Plans and Performance
(Billion Yuan)

	1979		1980		1981		1982		1983
	Plan	Final	Plan	Final	Plan	Final	Plan	Final	Plan
New Investment	--	50.0	50.0	53.9	30.0*	44.3	38.0*	55.5	50.7
From:									
Budget	36.0			28.1	17.0	20.76	18.63	19.2	26.1
		39.5							
Loans **	4.0			9.5		9.45	11.3	19.3	13.85
					13.0				
Retained Earnings	--	10.5		16.4		14.09	8.1	17.0	10.75

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*Plan revised to 38 billion yuan and 44.5 billion yuan, respectively, midway through 1981 and 1982; see text.

**Includes foreign exchange loans from Bank of China and domestic bank loans

Table 2: Chinese Industrial Plans and Performance

annual percentage change

	1979		1980		1981			1982		1983
	Plan	Final	Plan	Final	First Plan	Second Plan	Final	Plan	Final	Plan
Industrial Production	8.0	8.5	6.0	8.7	6.0	3.0	4.1	4.0	7.7	4.0
Light Industry	8.3	9.6	8.0	18.4	8.0	8.0	14.1	7.0	5.7	4.1
Heavy Industry	7.6	7.7	4.0	1.4	4.0	-2.0	-4.7	1.0	9.9	3.9

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